IN DISTRICT COURT, COUNTY OF CASS, STATE OF NORTH DAKOTA.

State of North Dakota, ex. rel., Wayne Stenehjem, Attorney General,

Plaintiff,

vs.

Philip Morris, Incorporated, Brown & Williamson Tobacco Corporation, Lorillard Tobacco Company, R.J. Reynolds Tobacco Company, Liggett Group, Inc., United States Tobacco Manufacturing Company, Inc., and United States Tobacco Sales and Marketing Company, Inc.,

Defendants.

File No. 09-98-C-03778

MEMORANDUM OPINION AND ORDER

The above-entitled matter comes before the Court on Defendant's Motion to Compel Arbitration of this matter.

The dispute, which the Defendants claim needs to be arbitrated, is the Plaintiff's Motion for Declaratory Relief. That motion seeks an order from this Court to enforce the Master Settlement Agreement between the parties, to declare that North Dakota has diligently enforced its Qualifying Statute during 2003, to declare the North Dakota's payments under the Master Settlement Agreement not be reduced by the "nonparticipating manufacture adjustment," and finally, to declare that certain participating manufacturers have waived or are estopped from asserting certain claims regarding North Dakota's enforcement of the Qualifying Statute with regard to the escrow deposit made on or about April 15, 2004, for cigarette sales in calendar year 2003.

BACKGROUND

A brief background is necessary. In the 1990's, the State of North Dakota and 45 other

states, as well as the District of Columbia, the Common Wealth of Puerto Rico and four territories (Settling States) brought suit against Defendants R.J. Reynolds Tobacco Company, Inc., (RJR) Lorillard Tobacco Company, Inc., (Lorillard), and Philip Morris, Inc., (Philip Morris). North Dakota's lawsuit basically alleged that the Defendant tobacco companies had conspired for decades to conceal from the American public the health risks related to smoking and intentionally targeting minors through marketing and promotional efforts.

In November, 1998, North Dakota and the other Settling States resolved their lawsuits against RJR, Lorillard and Philip Morris. The settlement was memorialized in the Master Settlement Agreement (MSA), and RJR, Lorillard, and Philip Morris became MSA "original participating manufacturers" (OPMs).

The MSA was approved by entry of a Consent Decree and Final Judgment by this Court on December 23, 1998.

The MSA permits cigarette manufacturers other than OPMs to join the MSA. These manufacturers, called Subsequent Participating Manufacturers (SPMs) must agree to make annual payments to the settling states and to adhere to the same restrictions as the OPMs on advertising, marketing, and other practices. At the present time, more than 45 manufacturers have joined the MSA as SPMs. Tobacco manufacturers that did not joint the MSA, known as Nonparticipating Manufacturers (NPMs), are not subject to the MSA's marketing restrictions, and do not make monetary payments to the Settling States under the MSA.

The MSA restricts the advertising, promotion, marketing and packaging of cigarettes, including a ban on targeting youth. It requires the PMs to make payments in perpetuity to the MSA states on or before April 15th of each year. North Dakota receives 0.3660138 percent

of each payment, and has received approximately $174,261,226.72 since the MSA was signed.

In April of 2006, RJR and Lorillard, along with several other PMs, withheld approximately $775,000,000 from the Settling States, claiming a nonparticipating member, (NPM) adjustment for the year 2003. North Dakota's current share of this reduction is approximately 2.75 Million Dollars. Other PMs, including Philip Morris, also have now claimed that they are entitled to reduce their future MSA payments as well.

THE MSA

The NPM adjustment in the MSA is tied to the PM's loss of Market Share. The MSA provides that the Independent Auditor, Price Waterhouse Coopers (Firm), will collect various information, and calculate the Market Share, the Market Share Loss, as well as adjustments to the MSA payments and allocation of payments among the Settling States. The NPM adjustment is discussed in Section IX(d)(1). Section IX(d)(2), provides in part as follows:

> Allocation among Settling States of NPM Adjustment for Original Participating Manufacturers.
>
> (A) The NPM Adjustment set forth in subsection (d)(1) shall apply to the Allocated Payments of all Settling States, except as set forth below.
>
> (B) A Settling State's Allocated Payment shall not be subject to an NPM adjustment: (i) if such Settling State continuously had a Qualifying Statute (as defined in subsection (ii)(E)(below) in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due and diligently enforced the provisions of such statute during such entire calendar year . . .
>
> (C) The aggregate amount of the NPM Adjustment that would have applied to the Allocated Payments of those Settling States that are not subject to an NPM adjustment pursuant to subsection (2)(b) shall be reallocated among all other Settling States prorate in proportion to the respective allocated shares,

> and such other Settling States Allocated Payments shall be further reduced accordingly . . .

The Firm concluded that for the 2003 calendar year, the MSA was "more likely than not" a significant factor in the Market Share Loss determined by the Firm. The Firm then determined that an NPM adjustment was in order pursuant to Section IX(d)(1) of the MSA.

In 2003, North Dakota had a "Qualifying Statute" as defined in Section IX(d)(2)(d) of the MSA. Although the Defendants have attempted to phrase their dispute with the Settling States in different ways, it is clear that the real dispute here is whether the State of North Dakota diligently enforced the provisions of such statute during such entire calendar year.

The Plaintiff claims that this Court has jurisdiction to determine that dispute. The Defendants maintain that that dispute is subject to mandatory arbitration under the MSA.

The Arbitration Agreement in the MSA provides as follows:

> Resolution of Disputes. Any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor (including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry-forwards and allocations described in subsection IX(j) or subsection XI(i)) shall be submitted to binding arbitration before a panel of three neutral arbitrators, each of whom shall be a former Article III federal judge. Each of the two sides to the dispute shall select one arbitrator. The two arbitrators so selected shall select the third arbitrator. The arbitration shall be governed by the United States Federal Arbitration Act.

MSA § XI(c). (Emphasis added).

Under North Dakota law, the parties' intent must be ascertained from the entire instrument and every clause, sentence, and provision shall be given effect consistent with the main purpose of the contract. US Bank Nat'l Assoc. v. Koenig, 2002 ND 137, ¶ 8, 650

N.W.2d 820, 822-23. A contract must be construed as a whole to give effect to each provision if reasonably practicable. Lenthe Inv., Inc., v. Service Oil, Inc., 2001 ND 187, ¶ 14, 636 N.W.2d 189, 194.

Interpreting the contract as a whole, as required by North Dakota law, requires this Court to look at other applicable provisions including, in part, the following:

> (a) Jurisdiction. Each Participating Manufacturer and each Settling State acknowledges that the Court: (1) has jurisdiction over the subject matter of the action identified in Exhibit D in such Settling State and over each Participating Manufacturer; (2) shall retain exclusive jurisdiction for the purpose of implementing and enforcing this Agreement and the Consent Decree as to such Settling State; and (3) except as provided in subsection IX(d), XI(c), and XVII(d) and Exhibit O, shall be the only court to which disputes under this Agreement or the Consent Decree are presented as to such Settling State . . .

MSA § VII(a). (Emphasis added).

Does IX(d) provide that some other decision maker other than this District Court decide the issue of diligent enforcement? Looking to IX(d), the Firm is charged with determining whether any provisions of the MSA were a significant factor contributing to a market share loss. Pursuant to IX(d)(C), it is that decision of the Firm which is conclusive and binding upon all parties, and shall be final and nonappealable. Section IX(d)(2), does not either explicitly or even impliedly provide that the Firm is charged with the responsibility of determining the diligent enforcement of the Qualifying Statute. The Court then concludes that Section VII(a) does not deprive this Court of jurisdiction to determine that issue.

Section VII(c), of the Agreement, provides as follows:

> Enforcement of this Agreement.
>
> (1) Except as provided in subsections IX(d), XI(c), and XVII(d)

> and Exhibit O, any Settling State or Participating Manufacturer may bring an action in the Court to enforce the terms of this Agreement (or for a declaration construing any such term ("Declaratory Order")) with respect to disputes, alleged violations or alleged breaches within such Settling State.

(Emphasis added).

Here too, the exception in (c) has no application because Section IX(d)(2) neither expressly or impliedly charges the Firm with making the determination of whether the statute has been diligently enforced. The Court then concludes that this provision does not deprive the Court of jurisdiction to hear this dispute.

The arbitration provision in the MSA provides "any dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor." (Emphasis added). In construing this provision, the Court is mindful that the arbitration process is strongly favored as a matter of public policy. Gratech Co., Ltd. v. Wold Engineering., P.C., 2003 ND 200, ¶ 14, 672 N.W.2d 672, 677. On the other hand, arbitration is a matter of contract and a party is contractually bound to arbitrate only those disputes which he or she has agreed to arbitrate. West Fargo Pub. Sch. Dist. No. 6 of Cass County v. West Fargo Ed. Assoc., 259 N.W.2d 612, 618 (N.D. 1977). Both under the Federal Arbitration Act and the Uniform Arbitration Act, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. All State Ins. Co. v. Nodak Mut. Ins. Co., 540 N.W.2d 614, 619 (N.D. 1995). This rule of construction, however, applies only if there is a broad arbitration clause with no exclusions. State v. Gratech Co., Ltd., 2003 ND 7, ¶ 12, 655 N.W.2d 417, 420. An implicit exclusion in the arbitration clause in the MSA, is that it excludes from the arbitration any disputes, controversies or claims that do not arise out of or relate to calculations performed by, or

any determinations made by, the Independent Auditor.

In construing the arbitration clause, contract law principles apply. See e.g., Lucas v. American Family Mut. Ins. Co., 403 N.W.2d 646 (Minn. 1987); Simpson v. Simpson, 194 Neb. 453, 232 N.W.2d 132 (1975); Bullis v. Bear, Streans & Co., Inc., 553 N.W.2d 599 (IA 1996); Grazia v. Sanchez, 199 Mich. App. 582, 502 N.W.2d 751 (1993).

The language in Section IX(c) which provides "(including, without limitation, any dispute concerning the operation or application of any of the adjustments, reductions, offsets, carry forwards and allocations described in subsection IX(j) or subsection XI(i))" must be construed under the doctrine of "ejusdem generis." Under that principle, general words which follow particular and specific words are not given their natural and ordinary sense, standing alone, but are confined to persons and things of the same kind, cost, nature, or genus as to particular words. Link v. Federated Mut. Ins. Co., 386 N.W.2d 897, 900 (N.D. 1986). Therefore, that quoted language is confined to the specific language in the arbitration clause, which states "relating to calculations performed by, or determinations made by, the Independent Auditor."

The words of a contract are understood in their ordinary and popular sense. Circle B Enterprises, Inc. v. Steinke, 1998 ND 164, ¶ 9, 584 N.W.2d 97, 100. Is the determination whether the State of North Dakota has diligently enforced its statute a dispute, controversy or claim arising out of or relating to calculations performed by, or any determinations made by, the Independent Auditor? The common and everyday understanding of the word "calculation," is "to ascertain or determine by mathematical process." WEBSTER'S THIRD INTERNATIONAL DICTIONARY 315 (1993). Clearly, the determination of whether the State of North Dakota diligently enforced its Qualifying Statute, is not a "calculation." This raises

the question whether or not the diligent enforcement issue was a determination made by the Independent Auditor. As stated earlier, in determining the construction of this language, the Court is allowed to look at the entire agreement. Section XI(a) of the Agreement charges the auditor with its responsibilities and states in part as follows:

> (a) Independent Auditor to Make All Calculations.
>
> (1) Beginning with payments due in the year 2000, an Independent Auditor shall calculate and determine the amount of all payments owed pursuant to this agreement, the adjustments, reductions and off-sets thereto (and all resulting carry-forwards, if any), the allocation of such payments, adjustments, reductions, offsets and carry-forwards among the participating manufacturers and among the Settling States, and shall perform all other calculations in connection with the foregoing (including, but not limited to, determining market share, relative market share, base aggregate participating manufacturer market share and actual aggregate participating manufacturer market share). The Independent Auditor shall promptly collect all information necessary to make such calculations and determinations. Each participating manufacturer and each settling state shall provide the Independent Auditor, as promptly as practicable, with information in its possession or readily available to it necessary for the Independent Auditor to perform such calculations . . .

The clear import of this language is that the auditor is charged with calculations. Nowhere is the auditor specifically charged with making a factual determination whether or not a state has diligently enforced its Qualifying Statute.

> Section XI(c) describes the types of calculations and determinations an auditor is to make under the MSA as "including, without limitation, any dispute concerning the operation or application of any of the adjustment, reductions, offsets, carry-forwards and allocations described in Subsection IX(j) or Subsection XI(i)" Those types of calculations and determinations appear to involve accounting matters and are not the type of complex mixed legal and factual determinations commonly decided by courts of law.

In Re: Tobacco Cases I, 124 Cal. App.4th 1095, 21 Cal. Rep.3d 875, 884 n. 6 (Cal.App.

2004). The Court went on to address further the arbitration clause in the MSA.

> In light of the clear language of the [arbitration clauses] phrase, which defines [the] types of "disputes" that require arbitration, namely "calculations performed . . . . or any determinations made by an" [auditor]," the meaning of the arbitration clause is plain and clear; only disputes involving calculations or determinations made by [auditor] require arbitration. Had the arbitration clause not contained any defining language restricting its scope, the clause could be read broadly enough to encompass the issues presented by the instant action. However, the clause clearly contains such restricted language and cannot, therefore, be fairly read to include within its scope any issues, other than, e.g., accounting or financial issues, addressed or made by [auditor].

Id. 879-80.

In that light, the Court must determine whether or not the issue of diligent enforcement of North Dakota's Qualifying Statute was a determination made by the Independent Auditor. In Price Waterhouse Cooper's letter of March 7, 2006, regarding its "Notice of Preliminary Calculations for the Tobacco Litigation Master Settlement Agreement," the auditor stated in part as follows:

> The Independent Auditor has received information request responses from some PMs denying that some Settling States have "continuously had a Qualifying Statute in full force and effect during the entire calendar year immediately preceding the year in which the payment in question is due [1999-2005], and diligently enforced the provisions of such statute during such entire calendar year." Subsection IX(d)(2)(B) of the MSA. The Settling States do not agree with this position. The Independent Auditor is not charged with the responsibility under the MSA of making a determination regarding this issue. More importantly, the Independent Auditor is not qualified to make the legal determination as to whether any particular Settling State has "diligently enforced" its Qualifying Statute. Additionally, the Independent Auditor is aware of certain litigation that is ongoing related to this issue. Until such time as the parties resolve this issue or the issue is resolved by a trier of fact, the Independent Auditor will not modify its current approach to the calculation.

(Emphasis added).

The Independent Auditor's current approach to the calculation was to "presume" "diligent enforcement." Was this then a determination of diligent enforcement made by the Independent Auditor? The word "determinations" should be given its commonly understood meaning. It is "the settling and ending of a controversy esp by judicial decision . . . . [or] the resolving of a question by argument or reasoning." WEBSTER'S THIRD INTERNATIONAL DICTIONARY 616 (1993). Here, the Independent Auditor did not settle and end the controversy whether or not the State of North Dakota diligently enforced its Qualifying Statute nor did the Independent Auditor resolve that question by argument or reasoning. By making a presumption or an assumption on that issue, the Independent Auditor supposed it to be true.

The Court concludes that the issue of whether the State of North Dakota diligently enforced its Qualifying Statute was not a "dispute, controversy or claim arising out of relating to calculations performed by, or any determinations made by, the Independent Auditor."

The Defendants also argue that public policy favors arbitration of this dispute because conflicting court rulings would affect the payments made to the other states. But the possibility of such conflicting court decisions does not require arbitration of this dispute. In fact, Section VIII(c) of the MSA contemplates possible conflicting court rulings by providing for enforcement of the MSA in separately designated courts for each of the 52 Settling States. In Re: Tobacco Cases I, Supra, at 888. "The possibility of conflicting court rulings is an inherent consequence of our decentralized political and judicial systems." Id. at 888-889.

Furthermore, the language of the MSA itself concerning diligent enforcement suggests that it is a state by state issue. Section IX(d)(2)(B), states that if such Settling State continuously had a Qualifying Statute . . . . and diligently enforced the provisions of such statute during such entire calendar year." (Emphasis added).

The Defendants also rely upon Section IX(j) of the MSA, which is entitled Order of Application of Allocations Offsets, Reduction, and Adjustments. It sets forth 13 steps that need to be taken to calculate the payments under the agreement. At oral argument, this was referred to as the "cookbook." The sixth item provides "the NPM adjustment shall be applied to the results of clause "fifth" pursuant to Subsections IX(d)(1) and (d)(2) . . . ." The Court agrees that Section IX(d)(2) is an "ingredient" in the "cookbook." But Section IX(j) is silent as to who determines whether a state diligently enforced its Qualifying Statute.

The Court is mindful of the other State District Court decisions that have compelled arbitration of this issue. Each of the Courts cited to the other decisions as a rationale for compelling arbitration.[1] The Court, however, does not find the reasoning of these decisions persuasive. If the Defendants had wished to require arbitration of this matter, they clearly could have spelled that out in the arbitration agreement. They did not. They could have incorporated a broad arbitration clause requiring arbitration of any and all disputes arising from the agreement. They did not do that as well. Here, the State of North Dakota did not agree to arbitrate the issue of diligent enforcement of the Qualifying Statute.

The Defendants also seemingly argue that a three person arbitration panel

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[1] State of New York v. Philip Morris, Inc., 813 N.Y.S.2d 71 (N.Y. App. Div. 2006);
State of Connecticut v. Philip Morris, Inc., 2005 WL 2081763 (Conn. Super. Ct. 2005);
State of New Hampshire v. Philip Morris, Inc., No. 06-E-132 (N.H. Super. Ct. 2006);
State of Kentucky v. Philip Morris, Inc., 98-C1-05179 (Ky. Cir. Ct. 2006);
State of Idaho v. Philip Morris, Inc., CV OC 9703239D (Idaho Dist. Ct. 2006).

consisting of Article Three Judges would be better qualified to resolve this dispute than a State District Court. The Court is not convinced. Whether or not the State of North Dakota diligently enforced its Qualifying Statute, is a question of local laws. Granted, it is an issue of national impact. But it is an issue that should be decided under North Dakota law by a North Dakota Court.

On the basis of the foregoing, IT IS HEREBY ORDERED that Defendants' Motion to Compel Arbitration of this matter is DENIED.

IT IS FURTHER ORDERED that Defendants shall have 30 days to file responsive briefs to the Plaintiff's Motion for Declaratory Relief.

Dated this 18th day of July, 2006.

BY THE COURT:

Steven L. Marquart
District Judge
East Central Judicial District